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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-15

CONTINENTAL T.V., INC., A & G SALES, SYLPAC, INC. and S.A.M. INDUSTRIES, INC., *Petitioners,*

v.

GTE SYLVANIA, INC., *Respondent.*

On Writ of Certiorari to the Court of Appeals for the Ninth Circuit

MOTION OF INTERNATIONAL FRANCHISE ASSOCIATION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE

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MOTION OF INTERNATIONAL FRANCHISE ASSOCIATION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

The International Franchise Association ("IFA") hereby respectfully moves, pursuant to Rule 42(3) of the Rules of this Court, for leave to file the attached brief *amicus curiae* in support of respondent in this case. The consent of the attorney for the respondent

has been obtained. The consent of the attorney for the petitioners was requested but refused.

The interest of IFA in this case arises from its role as a trade association for the franchise industry and the broad impact which this Court's decision may have upon that industry.

IFA was established in 1960 by a small number of franchisors in response to the burgeoning growth of franchising as a method of distribution for an expanding range of goods and services. In 1976 there were an estimated 457,693 establishments engaged in a myriad of franchised businesses, accounting for sales of goods and services exceeding $190 billion, including 28 percent of all retail sales in the United States, and employing more than 3.4 million people.[1]

IFA's current membership includes approximately 230 franchise companies representing more than 30 different industries, including automobile, truck and equipment rentals, automotive products and services, beverages, bicycles, books, clothing, convenience grocery stores, drugs, electronic products, employment agencies, hardware, home furnishings, hotels and motels, paint and decorating supplies, printing and copying, restaurants, soft drink bottling, tax return preparation, and a broad range of other personal service and retail sales businesses. The purposes and goals of IFA include providing business and legal education to franchisors and prospective franchisors through management seminars, legal symposia, newsletters and legal bulletins, and participating as a spokesman for

[1] U.S. Department of Commerce, *Franchising in the Economy* 1974-76, pp. 1, 5.

franchisors in legislative, judicial, and administrative matters relating to franchising.

In this private antitrust case, the Court of Appeals for the Ninth Circuit held that a limitation imposed by a manufacturer-franchisor upon the location from which a dealer-franchisee was authorized to offer the franchisor's product for resale should be judged under the rule of reason. *GTE Sylvania, Inc.* v. *Continental T.V., Inc.*, 537 F.2d 980 (9th Cir. 1976). Petitioners maintain that the restriction should be held unlawful *per se* under *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

IFA's interest in the issues presented is plain. As the court of appeals recognized, adoption of a *per se* rule "would have grievous implications for the common and established practices of franchising and the granting of exclusive dealerships" (537 F.2d at 998). The essence of most, if not all, franchising operations is the licensing of persons at different locations, and the franchisor frequently desires to enhance the effectiveness of his system by utilizing such common techniques as exclusive dealerships, which serve "as the stimulus for active product marketing by dealers" (*id.* at 1014, dissenting opinion). Reversal of the decision of the court of appeals could seriously jeopardize the manner of operation employed by numerous franchisors in various fields.

It is precisely in the area of franchising that *Schwinn* and its ramifications have their greatest impact, and IFA believes that the franchise industry perspective and experience will be helpful in assessing that impact. As *amicus curiae,* IFA will urge affirmance of the de-

cision below and a reconsideration of the *per se* rule of *Schwinn*.

Respectfully submitted,

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BRIEF AMICUS CURIAE OF INTERNATIOAL FRANCHISE ASSOCIATION

INDEX

Page

INTEREST OF AMICUS CURIAE INTERNATIONAL FRANCHISE ASSOCIATION 1

STATEMENT AND SUMMARY OF ARGUMENT 2

ARGUMENT:

I. The Court of Appeals Correctly Declined To Extend The *Per Se* Rule of Schwinn To Embrace Sylvania's Location Clause 3

II. Vertical Territorial and Customer Restrictions Should Not Be Deemed Unlawful *Per Se* But Instead Should Be Judged Under the Rule of Reason 7

A. *Schwinn's Per Se* Rule Should Be Reconsidered Because It Is Unsound As A Matter Of Antitrust Policy And Has Generated Confusion And Uncertainty 9

B. A *Per Se* Rule For Vertical Territorial and Customer Restrictions Is Unwarranted and Inappropriate 13

1. Vertical Territorial and Customer Restrictions Are "Ancillary" Rather Than "Naked" Restraints 14

2. Vertical Territorial and Customer Restrictions May Have Pro-Competitive Benefits 16

3. The Variety of Vertical Territorial and Customer Restrictions Precludes Formulation of A *Per Se* Rule 19

4. *Per Se* Condemnation of Vertical Territorial and Customer Restraints Has Fostered Vertical Integration 20

Page

C. The Rule of Reason Applies to Comparable Restraints and Should Govern 22

D. The Courts Are Fully Capable of Applying a Rule of Reason Standard To Vertical Restraints And Fashioning Flexible Rules Consistent With Economic Reality 25

TABLE OF AUTHORITIES CITED

CASES:

American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3d Cir. 1975) 23
Booth Bottling Co. v. Beverages International, Inc., 361 F.Supp. 340 (E.D. Pa. 1973) 11
Boro Hall Corp. v. General Motors Corp., 124 F.2d 822 (2d Cir. 1942) 4-5
Brown Shoe Co. v. United States, 370 U.S. 294 (1962) .. 28
Chicago Board of Trade v. United States, 246 U.S. 231 (1918) 8
Dr. Miles Medical Co. v. Park & Sons Co., 220 U.S. 373 (1911) 16
Fortner Enterprises, Inc. v. United States Steel, 394 U.S. 495 (1969) 28
GTE Sylvania, Inc. v. Continental T.V., Inc. ..... *passim*
Kaiser v. General Motors Corp., 396 F. Supp. 33 (E.D. Pa. 1975), *aff'd* 530 F.2d 964 (3d Cir. 1976) 5, 28
Northern Pacific Ry. v. United States, 356 U.S. 1 (1958) 8, 10, 14, 28
Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir), *cert. denied*, 355 U.S. 822 (1957) 22-23, 27
Response of Carolina, Inc. v. Leasco Response, Inc., 537 F.2d 1307 11

Page

Salco Corp. v. General Motors Corp., Buick Motor Div., 517 F.2d 567 (10th Cir. 1975) 5, 28
Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964) 22
Snap-On Tools v. FTC, 321 F.2d 825 (7th Cir. 1963) 22, 24
Standard Oil Co. v. United States, 221 U.S. 1 (1911) .. 7-8
Superior Bedding Corp. v. Serta Associates, Inc., 353 F. Supp. 1143 (N.D. Ill. 1968) 27
Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320 (1961) 23, 27
The Coca-Cola Co., 3 Trade Reg. Rep. ¶ 21,010 (FTC Ad. Law Judge 1975) 18
Timken Roller Bearing Co. v. United States, 341 U.S. 543 (1951) 26
Tomac, Inc. v. Coca-Cola Co., 1976-2 Trade Cas. ¶ 69,988 (C.D. Cal. 1976) 11, 27
Tripoli Co. v. Wella Corp., 425 F.2d 932 (3d Cir.), *cert. denied*, 400 U.S. 831 (1970) 11, 18
United States v. Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899) 14
United States v. Aluminum Co. of America, 148 F. 2d 416 (2d Cir. 1945) 21
United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) ..... *passim*
United States v. Arnold, Schwinn & Co., 1968 Trade Cas. ¶ 72,480 (N.D. Ill. 1968) 27
United States v. Colgate, 250 U.S. 300 (1919) 22
United States v. General Dynamics Corp., 415 U.S. 486 (1974) 28
United States v. Marine Bank Corp., Inc., 418 U.S. 602 (1974) 28
United States v. Parke Davis & Co., 363 U.S. 29 (1950) 22

Page

United States v. Topco Associates, Inc., 405 U.S. 596 (1972) 8, 9-10, 13, 26

United States v. Topco Associates, Inc., 1973-1 Trade Cas. ¶ 74,391 (N.D. Ill. 1973) 27

White Motor Co. v. United States, 372 U.S. 253 (1963) *passim*

STATUTES:

Sherman Act

15 U.S.C. § 1 ..... *passim*

ARTICLES:

A.B.A., *Antitrust Law Developments* (1975) 12

Baker, *Vertical Restraints in Times of Change: From White to Schwinn to Where?*, 44 Antitrust L.J. 537 (1975) 11, 12

Bork, *The Rule of Reason and the Per Se Concept: Price-Fixing and Market Division II*, 75 Yale L.J. 373 (1966) 15

Keck, *The Schwinn Case*, 23 Business Lawyer 669 (1968) 21

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Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 Law & Contemp. Prob. 506 (1956) 17

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Warren, *Economics of Closed-Territory Distribution*, 2 Antitrust L. & Econ. Rev. 111 (1969) 17

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BRIEF AMICUS CURIAE OF INTERNATIONAL FRANCHISE ASSOCIATION

INTEREST OF AMICUS CURIAE INTERNATIONAL FRANCHISE ASSOCIATION

The interest of *amicus curiae* International Franchise Association ("IFA") is set forth in IFA's motion for leave to file this brief, *supra.*

STATEMENT AND SUMMARY OF ARGUMENT

The central question before the court of appeals in this private antitrust action was "whether the district judge erred in concluding, and instructing the jury accordingly, that under the supposed rationale of *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), Sylvania's practice of fixing by agreement the locations from which Continental was authorized to sell Sylvania's products was illegal *per se* under Section 1 of the Sherman Act" (537 F.2d at 982).

Schwinn dealt with customer and territorial resale restrictions imposed by a manufacturer on its distributors and franchised retailers, rather than with the location clauses involved here. A minority of the court of appeals sitting *en banc* conceded that "*Schwinn* did not expressly outlaw location clauses by name" (537 F.2d at 1010) but was nevertheless "convinced that Sylvania-type location clauses and *Schwinn*-type territorial restrictions are identical in effect and are both *per se* illegal under the command of *Schwinn*" (*id.*). The majority held that this conclusion "reflects a misinterpretation of *Schwinn*, is inconsistent with the existing law permitting exclusive dealerships, and, most importantly, would seriously undermine, rather than implement, the major purpose of the Sherman Act" (*id.* at 988). Declining to extend "the rule of *per se* illegality established . . . [in *Schwinn*] to embrace the 'locations practice' utilized by Sylvania and others as a method of modern product distribution systems," the court of appeals held that "[t]he 'rule of reason' should have been applied, permitting inquiry into the competitive effect and reasonableness of the locations agreement in question" (*id.*).

The decision of the court of appeals was correct and should be affirmed. The court's thorough opinion fully supports the result reached and will be treated in detail by respondent; hence, in Point I, IFA discusses only the salient features of the decision.

Respondent has also urged this Court to reconsider the *per se* rule of *Schwinn* itself (Br. in Opp. at 18 n. 12). IFA's brief is principally addressed to that issue. IFA believes reconsideration is appropriate in light of the questionable soundness of the *Schwinn per se* rule and the almost unprecedented confusion and uncertainty it has generated for the courts and the business community alike—the very confusion *per se* rules ostensibly seek to avert. Further, IFA submits that compelling reasons of antitrust policy require that vertical territorial and customer restraints be appraised under a standard of reasonableness, which invites, rather than forecloses, an examination of their "actual impact . . . on competition." *White Motor Co.* v. *United States*, 372 U.S. 253, 263 (1963).

ARGUMENT

I. THE COURT OF APPEALS CORRECTLY DECLINED TO EXTEND THE PER SE RULE OF SCHWINN TO EMBRACE SYLVANIA'S LOCATION CLAUSE.

The court of appeals offered three principal reasons for refusing to extend the *Schwinn per se* rule to cover Sylvania's location clause. First, the court determined that location clauses, whose validity under the Sherman Act had repeatedly been sustained both before and after *Schwinn*—notably, in the decree on remand in *Schwinn* itself—differ significantly in competitive effect from the total elimination of intrabrand competition produced by the territorial restraints held *per*

se unlawful in *Schwinn* (537 F.2d at 988-97). Second, the court noted that to hold location clauses invalid *per se,* and thus to allow franchised dealers to establish additional outlets wherever they wished, would effectively destroy the common practice of granting exclusive dealerships, whose legality in non-monopoly settings has been affirmed by "a veritable avalanche of precedent" (*id.* at 997), and "would have grievous implications for . . . franchising" (*id.* at 998). The court's final, "and perhaps . . . most compelling," reason (*id.* at 1000) was its belief "that location agreements like the ones adopted by Sylvania may in some instances *promote*, rather than impede, competition" (*id.*, emphasis in original). Thus, judging these agreements under the rule of reason, rather than a rule of *per se* illegality, is appropriate.

The efforts of petitioners and the minority in the court of appeals to avert the force of these arguments do not withstand scrutiny.

1. Conceding that "*Schwinn* did not expressly outlaw location clauses by name" (*id.* at 1010) and that "the Sylvania territorial line may not be as clearly defined as that in *Schwinn*" (*id.* at 1009), the minority nevertheless asserts that the Sylvania and *Schwinn* practices are "identical in effect" (*id.* at 1010). The reasons why the two practices are not "identical" are elaborated in the majority opinion (*id.* at 988-97) and need not be reiterated.

2. The minority's attempt to escape the force of the judicial precedents sustaining the validity of location clauses both before and after *Schwinn* is entirely unpersuasive. For example, the leading case of *Boro Hall Corp.* v. *General Motors Corp.*, 124 F.2d 822 (2d Cir. 1942), is dismissed by the minority as "not in point" (537 F.2d at 1016), even though, on the minority's own description of that case, any differences between the practices of General Motors in that case and Sylvania are imperceptible. *Salco Corp.* v. *General Motors Corp., Buick Motor Div.*, 517 F.2d 567 (10th Cir. 1975), holding "the location clause . . . valid as a matter of law" (*id.* at 576), is viewed as unauthoritative (537 F.2d at 1016); and *Kaiser* v. *General Motors Corp.*, 396 F. Supp. 33 (E.D. Pa. 1975), *aff'd*, 530 F.2d 964 (3d Cir. 1976), affirming a summary judgment which found that *Schwinn* did not render location clauses unlawful, is not discussed by the minority at all.

Even more disturbing is the minority's effort to define location clauses out of existence. To the minority, the right to franchise by location would mean only the right to "specify the location at which a retailer is the manufacturer's authorized representative" (537 F.2d at 1011) or "to designate the location . . . for which a trade mark license is issued" (*id.* at 1012-13). That right would not permit the franchisor to forbid the opening of unauthorized locations. The court of appeals properly characterized this argument as "highly artificial and even spurious" (*id.* at 994 n. 22). The right to grant a franchise for a specific location, without the corollary right to preclude the franchisee from conducting essentially the same business in the franchisor's product at other, unauthorized, locations, is wholly illusory.

3. The minority concedes that "*Schwinn* expressly ordains the exclusive dealership to be an acceptable practice, as do cases on which the majority relies . . ." (*id.* at 1013). The majority found in those authorities a compelling basis for not deeming location clauses unlawful *per se,* observing (*id.* at 997-98):

> The accepted principle that a manufacturer may legally grant an exclusive dealership is rendered

> meaningless if he cannot legally use a location clause to prevent his other dealers from opening their own retail outlets in the same area. If a manufacturer cannot include a location restriction in a franchise agreement, he cannot do what the exclusive dealership cases hold is legal, i.e., promise that "I will not franchise another dealer in your area."

The minority's response is nothing less than astonishing. First, it maintains that exclusive dealerships and location clauses "are clearly distinguishable" from one another (*id.* at 1013); however, the majority's point was not that they are the same, but that they are, in the minority's own term, "interdependent" (*id.*). Next, the minority, noting that exclusive dealerships "serve . . . as the stimulus for active product marketing by dealers, concedes that their utility . . . resides in the ability to manipulate the density of sales outlets" (*id.* at 1014)—a form of "manipulation" of which the minority evidently approves while, at the same time, condemning the means of effecting it. Further, the minority's approval of the right to franchise by location, to "assign . . . spaced locations" and "approve locations" (*id.* at 1013-14) squarely contradicts its *per se* condemnation of Sylvania's location clause; it is a plain reflection, IFA submits, of the minority's tortured and unsuccessful effort to reconcile its position in this case with its realization that "*Schwinn* expressly ordains the exclusive dealership to be an acceptable practice" (*id.* at 1013).

In sum, the minority is unable to answer the majority's contention that exclusive dealerships and location clauses are "interdependent," and that to acknowledge the lawfulness of the former is to concede that the latter cannot be unlawful *per se*.

4. Finally, the minority would reject application of a rule of reason to Sylvania's location clause because, it is said, (a) the clause is contrary to the Sherman Act's purpose because it restrains dealer freedom (*id.* at 1018-22), and (b) the courts may not "weigh the loss of intrabrand competition against an alleged gain in interbrand competition" (*id.* at 1024). Both contentions reflect circular reasoning; they assume rather than demonstrate that a *per se* standard of illegality applies. If the rule of reason is the proper standard, then consideration of interbrand competition is not only permissible but essential. As this Court stated in sustaining certain of Schwinn's distribution practices under the rule of reason, "[a]pplication of the rule of reason here cannot be confined to intrabrand competition . . ." (388 U.S. at 382). And, of course, if the location clause is sustained under a rule of reason analysis, then by definition it will have been found *not* to be contrary to the purposes of the Sherman Act.

Thus, neither concern of the minority precludes a rule of reason analysis of Sylvania's location clause or warrants the draconian and undiscriminating rule of *per se* invalidation. The majority correctly refused to extend the *Schwinn per se* rule to Sylvania's arrangement, and its decision that the rule of reason applies should be affirmed.

II. VERTICAL TERRITORIAL AND CUSTOMER RESTRICTIONS SHOULD NOT BE DEEMED UNLAWFUL PER SE BUT INSTEAD SHOULD BE JUDGED UNDER THE RULE OF REASON.

Although section 1 of the Sherman Act (15 U.S.C. § 1) proscribes "every contract, combination . . . or conspiracy in restraint of trade or commerce," it has long been recognized that the proscription applies only to restraints which are found to be unreasonable. *Stand-*

ard Oil Co. v. *United States,* 221 U.S. 1 (1911). Application of the "rule of reason" requires consideration of the setting in which the restraint occurs, its purpose, "the nature of the restraint and its effect, actual or probable," to determine its impact on competition. *Chicago Board of Trade* v. *United States,* 246 U.S. 231, 238 (1918).

Such an inquiry may, however, be dispensed with in the case of *per se* offenses, "which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." *Northern Pacific Ry.* v. *United States,* 356 U.S. 1, 5 (1958). *Per se* treatment is very sparingly invoked; "[i]t is only after considerable experience with certain business relationships that courts classify them as *per se* violations of the Sherman Act." *United States* v. *Topco Associates, Inc.,* 405 U.S. 596, 607-08 (1972).

In *Schwinn,* this Court for the first time applied a *per se* standard to vertical, non-price, territorial and customer restrictions incident to "sales," while judging identical restrictions in cases of "consignment" under the rule of reason. "Perhaps no decision in the annals of antitrust has evoked more criticism,"[1] and the judicial difficulties *Schwinn* has produced are mirrored in the sharp division in the court of appeals in the instant case.

IFA believes that, after nearly ten years' experience with *Schwinn,* its *per se* rule ought to be reexamined. IFA further submits that application of a *per se* stand-

[1] Robinson, *Recent Antitrust Developments,* 75 Colum. L. Rev. 243, 270 (1975).

ard to vertical customer and territorial restrictions is unsound as a matter of antitrust policy, and that the courts should judge them instead under the rule of reason.

A. Schwinn's Per Se Rule Should Be Reconsidered Because It Is Unsound as a Matter of Antitrust Policy and Has Generated Confusion and Uncertainty.

There are three principal reasons why the *per se* rule of *Schwinn* has been so heavily criticized.[2]

First, the conditions which traditionally have been prerequisites to an addition to the limited category of *per se* offenses were absent in *Schwinn.* Only four years earlier, this Court had declined to apply a *per se* standard to such restraints, declaring (*White Motor Co.* v. *United States,* 372 U.S. 253, 261, 263 (1963)):

> This is the first case involving a territorial restriction in a *vertical arrangement;* and we know too little of the actual impact of both that restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us.
>
> * * * *
>
> . . . We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a "pernicious effect on competition and lack . . . any redeeming virtue" . . . and therefore should be classified as *per se* violations of the Sherman Act. (Emphasis in original.)

Coming only four years later, the *Schwinn per se* rule did not seem a product of "considerable [judicial]

[2] For a bibliography of the critical literature, *see* Robinson, *supra* n. 1 at 272 n. 182.

experience" (*United States* v. *Topco Associates, Inc.*, *supra*, 405 U.S. at 407 with such restraints and a clear demonstration that they inevitably have a "pernicious effect on competition and lack . . . any redeeming virtue." *Northern Pacific Ry.* v. *United States, supra*, 356 U.S. at 5.

The announcement of a *per se* rule came as a surprise;[3] "[i]t also swept aside a venerable body of law sustaining such restraints under the traditional rule of reason as legitimate means for fostering effective interbrand competition."[4]

Second, *Schwinn*'s stated rationale for applying a *per se* rule to sale transactions—"the ancient rule against restraints on alienation" (388 U.S. at 380)—was unpersuasive. It appeared to ignore entirely the

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[3] The *per se* issue was not presented by the parties or fully briefed and argued in this Court. In fact, the opinion noted (388 U.S. at 368): ". . . the United States has abandoned its contention that the distribution limitations are illegal *per se*. Instead we are asked to consider those limitations in light of the 'rule of reason.'"

[4] Robinson, *supra* n. 1, at 270. The decision is also ambiguous. The Court at once seems to establish a *per se* rule for sale transactions and to utilize a rule of reason analysis of the distribution system which contained the challenged restraints. Mr. Justice Stewart, dissenting, observed that the lower court in *Schwinn* had concluded that the territorial restrictions "were the product of a horizontal conspiracy between wholesalers. The District Court found 'a division of territory by agreement between the distributors . . . horizontal in nature'" (388 U.S. at 390). The district court did not rule that vertical territorial restraints were *per se* illegal. Mr. Justice Stewart believed that the majority had overlooked the fact that the district court had merely condemned a horizontal restraint. It is possible that the majority intended only to apply the *per se* rule to Schwinn's customer restrictions which arose from the same distribution arrangements that produced the horizontal territorial restrictions which the district court had condemned.

ancillary restraints doctrine,[5] and, perhaps more importantly, it seemed "a wooden and irrelevant formula" unrelated to a meaningful antitrust analysis of "vertical distributional restraints in the American economy today."[6] Further, invoking "the ancient rule" furnished little insight into the standards which were to govern in cases not involving the sale and resale of fully manufactured items (for example, service franchises, trademark and copyright licenses, or the sale of components or ingredients for processing).[7]

The third defect of *Schwinn*, which arose from the Court's reliance on "the ancient rule against restraints on alienation," was the anomalous treatment accorded to the same restraint depending on whether it arose in the context of a "sale" or a "consignment"; the former was unlawful *per se*, the latter to be tested under the rule of reason. Thus, form, not an analysis of competitive effect, was to govern.

No aspect of *Schwinn* has been more severely criticized. "The majority offered no explanation why the mere passage of ownership in the goods could convert

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[5] 388 U.S. at 391-92, 394 (Stewart, J., dissenting); *see also* Robinson, *supra* n. 1 at 271: ". . . it is doubtful that an undeviating rule against such restraints ever existed, even at common law . . . ."

[6] 388 U.S. at 392 (Stewart, J., dissenting).

[7] *See* Robinson, *supra* n. 1 at 275; *see also* Baker, *Vertical Restraints in Times of Change: From White to Schwinn to Where?*, 44 Antitrust L.J. 537,538 (1975). This was, of course, not the only source of confusion in *Schwinn*. *See, e.g., Response of Carolina, Inc.* v. *Leasco Response, Inc.*, 537 F.2d 1307, 1315 (5th Cir. 1976): "The post-*Schwinn* treatment of the 'firm and resolute enforcement' language of the Court has followed an erratic course." With respect to the "without more" language of the majority opinion in *Schwinn*, *see Tripoli Co.* v. *Wella Corp.*, 425 F.2d 932 (3d Cir.), *cert. den.*, 400 U.S. 831 (1970); *Tomac, Inc.* v. *Coca-Cola Co.*, 1976-2 Trade Cas. ¶ 60,998 (C.D. Cal. 1976); *Booth Bottling Co.* v. *Beverages International, Inc.*, 361 F. Supp. 340 (E.D. Pa. 1973).

distribution arrangements which were found to 'preserve . . . competition' into restrictions which destroy it."[8] Interbrand competition is heavily relied on by the Court in treating consignments under the rule of reason; if a sale occurs, interbrand competition is to be ignored. The commercial implications of the form of a transaction generally are determined by the contracting parties, often on the basis of custom in the trade, and may vary from setting to setting.[9] However important, they are irrelevant in assessing the competitive impact of the restraint in question. Yet, *Schwinn* makes the form of the transaction controlling—an approach characterized by the present head of the Antitrust Division of the Department of Justice as "an exercise in barren formalism" and "unsound antitrust policy."[10]

For these reasons. *Schwinn*'s harsh and inflexible *per se* rule has fostered not certainty and judicial economy but confusion and a plethora of litigation.[11] It appears "artificial and unresponsive to the competitive needs of the real world."[12] The issue here is not whether these vertical restraints should always be deemed lawful; it is, rather, whether or not the courts

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[8] Robinson, *supra* n. 1 at 271.

[9] "Consignment" may be but one of several means of extending credit to a dealer. Risk of loss due to market fluctuation or casualty may not coincide with passage of title but instead determine who has responsibility for obtaining insurance. And a manufacturer who parts with "title" hardly has parted with the "risk" of losing the good will of consumers if the product is poorly distributed or serviced.

[10] Baker, *supra* n. 7 at 537.

[11] For a summary of the judicial experience, *see* Robinson, *supra* n. 1 at 272-75; *see also* A.B.A., *Antitrust Law Developments* 26 (1975).

[12] Baker, *supra* n. 7 at 537.

should be prevented from examining their competitive effect. The *Schwinn per se* rule presently bars such an examination. The rule, and the problems it has spawned, should be reconsidered.

B. A Per Se Rule for Vertical Territorial and Customer Restrictions Is Unwarranted and Inappropriate.

The antitrust concept of *per se* illegality is by definition inflexible. If a restraint is deemed to be a *per se* violation, it is unlawful regardless of its purpose or economic effect.

Application of an overbroad or poorly considered *per se* rule may thus disallow many socially valuable and economically meritorious transactions. Accordingly, the principle of *per se* illegality has always been viewed as a narrow exception to the traditional antitrust "rule of reason" analysis. As this Court has recognized, formulations of *per se* rules are appropriate only for "naked restraints of trade with no purpose except stifling of competition" (*White Motor Co.* v. *United States*, 372 U.S. 253, 263 (1963)), and that determination is not lightly undertaken. *United States* v. *Topco Associates, Inc.*, 405 U.S. 596, 607-08 (1972). Thus, *per se* rules are applied only where the courts have found over the years, by experience and analysis, that a particular, well-defined trade practice is utterly without justification, thereby making a factual inquiry into its economic impact irrelevant.

With respect to vertical territorial and customer restrictions, the criteria for adopting a rule of *per se* illegality have simply *not* been met. As discussed more fully below, such restrictions are not "naked re-

straints" among competitors, but instead are "ancillary" to the overall business relationship between a franchisor and his dealers. Moreover, these types of restrictions can, and indeed do, serve many legitimate and economically desirable business purposes which are decidedly pro-competitive or socially beneficial.

1. Verticle Territorial and Customer Restrictions Are "Ancillary" Rather Than "Naked" Restraints.

The distinction between "naked" restraints of trade, designed solely to hinder competition, and other restrictions which are "ancillary" to a legitimate business purpose was articulated in the earliest decisions applying the Sherman Act. *E.g., United States* v. *Addyston Pipe & Steel Co.*, 85 F. 271 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899). The classic *per se* rules developed by this Court—those involving price-fixing agreements among competitors, horizontal market division and group boycotts—are directed against restraints which clearly fall within the "naked" classification. These types of agreements involve combinations of direct competitors designed solely to restrict production or maintain prices. The prospect for offsetting economic efficiencies resulting from such arrangements is nil. They are appropriately subject to *per se* treatment. *Northern Pacific Ry.* v. *United States*, 356 U.S. 1, 5 (1958).

Vertical territorial and customer restraints, on the other hand, arise out of a much different economic context. Such limitations on intrabrand competition may have the effect of fostering interbrand competition by enhancing the competitive ability of the fran-

chisor.[13] Territorial or customer restrictions imposed upon dealers by the franchisor, in the exercise of its business judgment, are ancillary to the primary objective of achieving effective distribution of the franchisor's products or services in the competitive marketplace.

In many cases, the relationship between the franchisor and its dealers involves patent, trademark or some similar form of licensing. Many lower court decisions both before and after *Schwinn* refused to apply a rule of *per se* illegality to vertical customer and territorial restrictions which are reasonably ancillary to such licensing arrangements. Indeed, petitioners apparently concede that such restrictions are not *per se* violations of the antitrust laws and ackowledge that a "manufacturer may . . . use a location clause to protect its good will, and its property rights in its name and mark" (Pet. Br. 47-48).[14]

The same arguments which support ancillary restrictions in the vertical licensing context, however, also apply to more general vertical territorial and customer restraints. In each case, the franchisor seeks to achieve

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[13] *See* Bork, *The Rule of Reason and the Per Se Concept: Price-Fixing and Market Division II*, 75 Yale L.J. 373, 402 (1966).

[14] In attempting to avoid application of this principle to the instant case, petitioners seem to argue that because Sylvania did not grant exclusive dealerships, it should not be entitled to impose the corollary territorial restriction (Pet. Br. 45). This argument is unsound. Sylvania unilaterally limited the number of dealers in each market; the essence of its "elbow room" policy of spacing dealers was to give each dealer an adequate market in order to justify his commitment to Sylvania products. The location restriction was clearly ancillary to this policy.

an efficient distribution system in order to compete more effectively against similar products and services of other manufacturers, thereby achieving the economic goal of interbrand competition. Indeed, this is the manufacturer's sole objective and the restraint is thus clearly an ancillary one. At the same time, the franchisor retains a significant interest in protecting and enhancing the goodwill—reflected in quality and service—associated with its products. Accordingly, vertical restrictions which are reasonably designed to preserve goodwill and increase the efficiency of the distribution process are clearly ancillary restraints.

2. Vertical Territorial and Customer Restrictions May Have Pro-Competitive Benefits.

A *per se* rule against vertical territorial and customer limitations is appropriate only if their anticompetitive effects clearly outweigh their benefits. For example, efforts by manufacturers to impose a uniform resale price on distributors (*i.e.*, vertical price-fixing) have long been held to be *per se* illegal under the Sherman Act. *Dr. Miles Medical Co.* v. *Park & Sons Co.*, 220 U.S. 373 (1911). Significantly, such restraints "reduce price competition not only *among* sellers of the affected product, but quite as much *between* that product and competing products," [15] since distributors are thereby precluded from adjusting their prices to meet interbrand competition.

Vertical territorial and customer restrictions, on the other hand, do not hinder interbrand price competition because each dealer remains free to lower his price in

[15] *White Motor Co.* v. *United States*, 372 U.S. 253, 268 (1963) (Brennan, J., concurring, emphasis in original). *See also*, Note, *Territorial Restrictions and Per Se Rules—A Re-evaluation of the Schwinn and Sealy Doctrines*, 70 Mich. L. Rev. 616, 638-39 (1972).

response to competition from other products. Moreover, those restrictions frequently have positive benefits. For example, a system of territorial exclusivity eliminates wasteful duplication of sales effort and encourages each dealer to develop his marketing area for the franchisor's product to the maximum extent. Dealers have an incentive to engage in merchandising and furnishing point-of-sale services; to undertake costly training of sales and service personnel; to handle complaints; and to provide post-sale services, knowing that the money and sales effort thus expended can likely be recaptured through future sales in the territory. Such activities, especially specialized selling and servicing techniques, often are essential to maintain good will and to preserve the competitive position of the franchisor's product.

In the absence of a territorial limitation a particular dealer may seek to take a "free ride" on the market development work of his intrabrand rivals. In these circumstances the other dealers have little motivation to continue their sales and servicing efforts.[16] Without some form of territorial exclusivity, moreover, dealers may compete only for the largest accounts and leave smaller customers unserviced.[17]

[16] Warren, *Economics of Closed-Territory Distribution*, 2 Antitrust L. & Econ. Rev. 111,116 (1969):

> There is good reason to believe that the promise of freedom from intraband competition is in fact . . . essential to induce the dealer to promote the product in certain ways. Without such a promise of closed-territory distribution, the dealer is less assured that some of these forms of promotion will bring adequate returns.

[17] Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 Law & Contemp. Prob. 506 (1965).

Vertical restrictions may also be justified in particular circumstances. With respect to new products, new firms, failing companies and products which require substantial capital investment for distribution, the franchisor may need to grant territorial exclusivity in order to attract dealers willing to handle the products. Indeed, in *Schwinn,* the Court recognized that such restrictions may be necessary for the "newcomer," a "failing company," or in other similar "appropriate and compelling competitive setting[s]" (388 U.S. at 374, 379).

Vertical intrabrand restraints may also be necessary in certain industries to solve peculiar and unique distribution problems. In the soft drink industry, for example, it has been found that territorial exclusivity facilitates the use of returnable bottles, which is not only environmentally desirable but also permits delivery of the product to the consumer at a substantially lower cost.[18] Similarly, a customer restriction confining a distributor of beauty care products to professional beauticians and barbers has been upheld as necessary to minimize product liability exposure and protect consumer health and safety.[19]

In sum, vertical territorial and customer limitations have the potential to promote many social and business benefits. Accordingly, a *per se* rule is wholly inappropriate.

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[18] *The Coca-Cola Co.*, 3 Trade Reg. Rep. ¶ 21,010 (FTC Ad. Law Judge 1975).

[19] *Tripoli Co.* v. *Wella Corp.*, 425 F.2d 932 (3d Cir.), *cert. denied*, 400 U.S. 831 (1970).

3. The Variety of Vertical Territorial and Customer Restrictions Precludes Formulation of a Per Se Rule.

A broad *per se* rule for vertical distribution limitations would condemn indiscriminately a wide variety of practices. Each of these practices, in the context of the particular industry in which it is applied, may have benefits which far outweigh any anti-competitive effects.

Territorial restrictions alone may take many different forms. They may be cast as an absolute limitation, a profit passover arrangement, a location clause, or an area of primary responsibility. *See Sylvania, supra,* 537 F.2d at 995 n. 25. Similarly, customer limitations may distinguish between wholesale or bulk transactions as opposed to retail sales, or differentiate specific classes of potential accounts on a governmental, professional or similar basis. All these forms of restrictions may be associated with trademark, know-how, patent or copyright licensing. Such restrictions may be adopted to meet the peculiar need of a specific industry. Their impact in that context may be highly pro-competitive or socially beneficial, even though the same restraint, in another industry, may be anti-competitive.

A rigid, *per se* rule cannot take account of this wide range of differing practices utilized in many disparate industries. Rather, those practices should be tested by the traditional rule of reason analysis, which permits particularized consideration of their competitive impact.

4. PER SE CONDEMNATION OF VERTICAL TERRITORIAL AND CUSTOMER RESTRAINTS HAS FOSTERED VERTICAL INTEGRATION.

In *Schwinn,* this Court suggested that "a *per se* rule . . . applied to prohibit all vertical restrictions of territory and all franchising" might "sharply accelerate the trend toward vertical integration of the distribution process" (380 U.S. at 379-80).

The Court's observation was very much on target. The *per se* rule, when it has been applied to vertical territorial or customer restraints, has had precisely that anti-competitive effect.

The experience of Schwinn itself is illustrative.[20] Only about 25 percent of its sales were affected by the decision, yet it determined that to market its product effectively in the real business world it must retain a degree of control over the marketing of 100 percent of its production which the decision prohibited. Prior to the litigation, Schwinn distributed through 22 independent wholesalers. At the time of the entry of the final decree in the district court, the number of Schwinn wholesale distributors had been reduced to 18. Moreover, the company had announced that it would assume the wholesale function, eliminating all of the independent distributors. Schwinn's vertical integration was implemented shortly thereafter.[21]

[20] The Government had expressed confidence, in its brief in *Schwinn*, that it was not likely that the company would integrate vertically. It stated (Brief for United States at 28-29):

> Schwinn has not shown that its outlet restriction is necessary to meet the competition of integrated bicycle manufacturers—so far as appears, there are none. And Schwinn is unlikely to integrate into wholesaling and retailing if the contractual arrangements here challenged are barred, in view of the heavy expense such a course would entail and the lack of competitive necessity therefor.

There is, in our economy, a strong trend toward selective distribution of the type utilized by both Schwinn and Sylvania. An ever-increasing number of manufacturers are concluding that distribution through a limited group of distributors and dealers, who will effectively promote and market the manufacturer's product and provide necessary service, is essential to effective marketing. Inherent in the concept of selective distribution are some limitations on the marketing decisions of distributors and dealers. Schwinn had to limit sales by its distributors to franchised dealers; Sylvania must limit the locations from which its dealers may sell its products. As noted above, the arrangements between franchisor and franchisee take many different forms but achieve substantially the same substantive effect. *See* pp. 14-16, 19, *supra.*

If the law is out of step with essential elements of selective distribution, businessmen have but two choices: vertically integrate or go out of business. Schwinn chose the former; Sylvania and others might well have to choose the latter.[22]

[21] *See* Keck, *The Schwinn Case,* 23 Business Lawyer 669, 686-87 (1968).

[22] Vertical territorial and customer limitations also serve the social goal of the antitrust laws to protect small business units. *See United States* v. *Aluminum Co. of America,* 148 F.2d 416, 429 (2d Cir. 1945). In many industries, an exclusive territory may be the only alternative to vertical integration. *See Schwinn, supra,* 388 U.S. at 386-88 (Stewart, J., dissenting).

C. The Rule of Reason Applies to Comparable Restraints and Should Govern.

Until *Schwinn,* resale price fixing was the sole vertical restriction which was deemed to be *per se* unlawful. After "considerable experience," this Court concluded that resale price fixing by agreement was properly categorized as a *per se* violation. *See, e.g., United States* v. *Colgate,* 250 U.S. 300 (1919); *United States* v. *Parke Davis & Co.,* 363 U.S. 29 (1950).

Prior to *Schwinn,* all other vertical restraints were judged under the rule of reason. Perhaps the oldest and most common vertical restraint is the exclusive dealership or franchise: the manufacturer agrees that he will not establish another dealership in the dealer's sales territory. Sometimes, the manufacturer imposes this restraint upon itself, typically in order to induce the requisite financial commitment and market development effort by its dealers. *See, e.g., Sandura Co.* v. *FTC,* 339 F.2d 847 (6th Cir. 1964); *Snap-On Tools* v. *FTC,* 321 F.2d 825 (7th Cir. 1963). In a market of increasingly larger, integrated wholesaler-retailers, exclusive dealerships are often imposed by the buyer upon the seller.

The exclusive dealership is a form of restriction which may significantly restrain trade. It interferes with the manufacturer's freedom to choose customers, forecloses any other person from becoming a distributor in the territory and, as a practical matter, may prevent retailers within the territory from buying from any other distributor. Exclusive dealerships have nonetheless, and accurately, been characterized as *per se legal,* unless the manufacturer is a monopolist. *See Packard Motor Car Co.* v. *Webster Motor Car Co.,*

243 F.2d 418 (D.C. Cir.), *cert. denied,* 355 U.S. 822 (1957).

A second vertical restraint is exclusive dealing: the dealer agrees that he will sell only the manufacturer's product line or that he will not sell competitive products. The validity of exclusive dealing agreements is tested under a rule of reason by analysis of the extent to which the market is foreclosed to competing manufacturers. *Tampa Electric Co.* v. *Nashville Coal Co.,* 365 U.S. 320 (1961).

A form of exclusive dealing that has developed in modern franchising is the in-term covenant not to compete—an agreement by the franchisee not to engage in a similar business under either another franchise or his own name during the term of his franchise. This restriction is also tested under the rule of reason. *See American Motor Inns, Inc.* v. *Holiday Inns, Inc.,* 521 F.2d 1230 (3d Cir. 1975).

Another category of vertical restraint is the wide variety of restrictions designed to concentrate the efforts of a dealer in a specified territory. These arrangements include exclusive territories, location restrictions, areas of primary responsibility, quotas and profit passover requirements. They complement exclusive dealerships; a manufacturer must concentrate the marketing efforts or locations of each dealer in order to insure the benefits of an exclusive dealership to any dealer. All such restraints are tested under the rule of reason.[23]

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[23] Until 1948, all non-price vertical restrictions were unchallenged. Thereafter, a number of manufacturers entered into consent decrees with the Government which prohibited territorial restraints, but generally permitted location restrictions and areas

A final category of vertical restraints is customer restrictions. Such restrictions are occasionally utilized to reserve specialized accounts for direct sales by the manufacturer.[24] However, they are primarily an adjunct of selective distribution and franchise systems. If a manufacturer determines that its products can be most effectively marketed through selected authorized distributors and dealers, it must implement that marketing plan by requiring that distributors sell only to authorized dealers and prohibiting authorized dealers from selling to unauthorized dealers.

In sum, the rule of reason applies to the primary restraints of exclusive dealerships—the purpose and effect of which is to "space" dealers and insulate them to a degree from intrabrand competition—and to exclusive dealing—which reduces interbrand competition. Both exclusive dealerships and exclusive dealing have the capacity to restrain competition substantially. Yet this Court has never hesitated to permit their legality to be tested under the rule of reason. If the lower courts can be entrusted with the task of applying a rule of reason standard to such restraints of trade, they should be afforded the same latitude in assessing the territorial and customer restraints considered in *Schwinn* and in this case.

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of primary responsibility. White Motor Company refused to settle the Government's claim, resulting in summary judgment for the Government in the district court and a reversal by this Court with instructions to establish a record that would permit an analysis of the effects of such restrictions on competition. *White Motor Co.* v. *United States*, 372 U.S. 253 (1963).

[24] *See, e.g., Snap-On Tools* v. *FTC*, 321 F.2d 825 (7th Cir. 1963).

D. The Courts Are Fully Capable of Applying a Rule of Reason Standard to Vertical Restraints and Fashioning Flexibile Rules Consistent with Economic Reality.

The minority below argued that the courts are not the appropriate arbiters of economic policy issues and that it is inappropriate for them to attempt to weigh the relative merits of interbrand and intrabrand competition (*see* 537 F.2d at 1018-29, Browning, C.J., dissenting). IFA submits that this argument is fundamentally unsound, as Judge Duniway pointed out in his brief dissent. He was (*id.* at 1030)

> . . . puzzled by the notion that because the courts are not very well equipped to decide between conflicting notions of economic policy, they should pick one side of such an argument and erect it into a rule of *per se* illegality.

In fact, Congress did not distinguish between intrabrand and interbrand competition. Congress declared that restraints of trade are unlawful. This Court has interpreted that legislative pronouncement to mean that unreasonable restraints, not all restraints, are unlawful. Congress has charged the courts to protect competition. The rule of reason is an analytical tool to achieve that end. In the context of vertical restraints, it is neutral favoring neither interbrand nor intrabrand competition. A *per se* rule, however, favors intrabrand competition, for it forecloses inquiry into the impact of a vertical restraint on interbrand competition, which may well be the most significant form of competition. Thus, if the courts declare vertical restraints to be *per se* unlawful without regard to their overall impact on competition, they fail to meet their responsibility to uphold competition. By contrast, when the courts analyze the impact of a ver-

tical restraint on both interbrand and intrabrand competition, they do no more than Congress has charged them to do. As this Court noted in *Schwinn* (388 U.S. at 382), "[a]pplication of the rule of reason here cannot be confined to intra-brand competition."

Petitioners, relying upon *Topco,* argue that it is not the proper role of the judiciary to "set sail on a sea of speculation in a prophetic effort to tell whether the resulting inquiry [to intrabrand competition] is offset by asserted benefits to interbrand competition" (Pet. at 14). *Topco,* however, was concerned with horizontal, not vertical, restraints (405 U.S. at 608). Horizontal allocation of sales territories has long been classified as *per se* unlawful. *See Timken Roller Bearing Co.* v. *United States,* 341 U.S. 543 (1951). The statements in the Court's opinion in *Topco* regarding the difficulty of weighing destruction of competition in one sector of the economy against promotion of competition in another sector must be read in light of the nature of the restraints at issue in *Topco* and the asserted justification for those restraints. Topco argued that its territorial restrictions enabled Topco members to compete more effectively against the private brands of supermarket chains (405 U.S. at 605). But the horizontal territorial allocation of the Topco system not only foreclosed competition between Topco members in Topco brand products, it had the practical effect of foreclosing competition between them in all other products which Topco stores carried. The horizontal territorial allocation in the Topco system thus reduced significantly both intrabrand and interbrand competition.

Vertical restrictions present an entirely different analysis from that which this Court rejected in *Topco.*

The typical inquiry in the case of vertical restrictions is the extent to which intrabrand competition is diminished and whether such restrictions are essential to attract effective dealers who thereby become effective interbrand competitors. *See Tomac, Inc.* v. *Coca-Cola Co.,* 1976-2 Trade Cas. ¶ 60,988 (C.D. Cal. 1976).

This case illustrates the point perfectly. The uncontradicted evidence is that Sylvania had a one-to-two percent share of the market under its restriction-free distribution system and tripled its share to five percent after it adopted an "elbow room" policy. Before it adopted that policy, Sylvania was in serious danger of dropping out of the television set market which is dominated by Zenith and RCA. *See* 537 F.2d at 982. With its implementation, Sylvania became a significant competitor in that market (*id.* at 982-83). Interbrand competition in the product of a company with a one-to-two percent market share is far less significant than the interbrand competition afforded by a company that triples its market share by means of vertical restrictions.

The courts presently apply a rule of reason standard to exclusive dealerships,[25] exclusive dealing,[26] areas of primary responsibility,[27] profit passover requirements,[28]

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[25] *See, e.g., Packard Motor Car Co.* v. *Webster Motor Car Co.,* 243 F.2d 418 (D.C. Cir.), *cert. denied,* 355 U.S. 822 (1957).

[26] *Tampa Electric Co.* v. *Nashville Coal Co.,* 365 U.S. 320 (1961).

[27] *See* final decrees in *United States* v. *Arnold, Schwinn & Co.,* 1968 Trade Cas. ¶ 72,480 (N.D. Ill. 1968); *United States* v. *Topco Associates, Inc.,* 1973-1 Trade Cas ¶ 74,391 (N.D. Ill. 1973).

[28] *See Superior Bedding Corp.* v. *Serta Associates, Inc.,* 353 F. Supp. 1143 (N.D. Ill. 1968).

location restrictions,[29] and both horizontal and vertical mergers.[30] Tying arrangements, although sometimes described as illegal *per se*, involve a determination whether the defendant has sufficient market power over the tying product and whether a lesser restraint could achieve the necessary quality control or trademark protection.[31] Only price-fixing, horizontal allocation of sales territories or customers, and boycotts are true *per se* offenses. The courts are thus required to apply a rule of reason analysis to a wide variety of trade restraints, to consider their competitive impact and determine whether they are unreasonable and therefore unlawful. The decision to remove a class of restraints from the rule of reason category and place it in the *per se* category is not based on the inability of the courts to assemble and analyze evidence of competitive impact or on the judicial economy of avoiding such inquiries, but upon the conclusion that the restraints have a "pernicious effect on competition and lack . . . any redeeming virtue." *Northern Pacific Ry.* v. *United States*, 356 U.S. 1, 5 (1958).

Nor are the courts incapable of fashioning analytical rules for assessing the competitive impact, and ultimately the reasonableness, of vertical territorial and customer restraints. The courts are continually pre-

[29] *See Salco Corp.* v. *General Motors Corp., Buick Motor Div.*, 517 F.2d 567 (10th Cir. 1975); *Kaiser* v. *General Motors Corp.*, 396 F.Supp. 33 (E.D. Pa. 1975), *aff'd*, 530 F.2d 964 (3d Cir. 1976).

[30] *United States* v. *General Dynamics Corp.*, 415 U.S. 486 (1974) (horizontal); *United States* v. *Marine Bank Corp., Inc.*, 418 U.S. 602 (1974) (horizontal); *Brown Shoe Co.* v. *United States*, 370 U.S. 294 (1962) (vertical).

[31] *Fortner Enterprises, Inc.* v. *United States Steel*, 394 U.S. 495 (1969).

sented with factual and legal determinations under antitrust law which are at least equally complex. The courts must, for example, determine what constitutes a relevant market or submarket (involving such economic and marketing questions as interchangeability of use and cross-elasticity of demand), the extent of the market foreclosure of an exclusive dealing agreement, whether there has been an attempt to monopolize and a dangerous probability of a successful attempt, and whether a merger may tend to reduce or promote competition. Indeed, this Court's analysis of Schwinn's marketing system and the inquiry by the court of appeals below into the historical basis for and operative effect of Sylvania's "elbow room" policy amply demonstrate the ability of the courts to apply the rule of reason to vertical restraints.

Finally the nature of the inquiry into the reasonableness of a vertical territorial restraint is well understood. The factors to be assessed include the relative significance of intrabrand and interbrand competition in the market—whether the manufacturer dominates its market, or, like Sylvania, has a relatively small market share and faces larger and more vigorous competitors;[32] the extent to which intrabrand com-

[32] The reasonableness of an exclusive dealing agreement depends upon the degree to which it forecloses the market to competing sellers. The reasonableness of territorial restraints depend, at least in part, on the manufacturer's share of the market. The larger the share, the more dependent the market is on intrabrand competition in the manufacturer's product, and the less likely that the territorial restriction is necessary or can be justified by its beneficial effect on interbrand competition. It is one thing for Sylvania to restrict intraband competition in order to improve its effectiveness as an interbrand competitor. It would be quite another for RCA or Zenith to do so, for they are market leaders, and overall competition in the market would be damaged by the diminution of intrabrand competition in RCA or Zenith products.

petition is diminished by the territorial restraint; the market factors which led to the adoption of the restrictive practices; whether the territorial restriction is accompanied by other restrictions, such as exclusive dealing, that diminish interbrand competition; and, whether the territorial restriction is reasonably necessary to promote effective dealer marketing efforts and service, thereby enhancing interbrand competition.

The courts presently apply a rule of reason standard to many common marketing techniques, such as exclusive dealerships, exclusive dealing, and a number of restrictions on distributors and dealers that insulate them to some degree from intrabrand competition. The courts are fully capable of applying the rule of reason to all vertical territorial and customer restraints. There is no sound reason to foreclose them from doing so.

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals should be affirmed, and the *per se* rule announced in *Schwinn* should be replaced by the rule of reason.

Respectfully submitted,

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